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Warner Music Group F1Q07 (Qtr End 12/31/06) Earnings Call Transcript

posted on: February 08, 2007 | about stocks: WMG

Warner Music Group Corp. (WMG)
F1Q07 Earnings Call
February 8, 2007 8:00 am ET

Executives

Jill Krutick - Senior Vice President, Investor Relations and Corporate Development
Edgar Bronfman - Chairman of the Board, Chief Executive Officer
Michael D. Fleisher - Chief Financial Officer, Executive Vice President

Analysts

Doug Mitchelson - Deutsche Bank
Eric Handler - Lehman Brothers
Ingrid Cheung - Goldman Sachs
Bishop Cheen - Wachovia Securities
Michael Savner - Banc of America Securities
Jolanta Masojada - Credit Suisse
Mark Sugarman - Citigroup

Ian Whittaker - UBS

Presentation

Operator

Welcome to Warner Music Group's fiscal first quarter earnings call for the period ended December 31, 2006. At the request of Warner Music Group, today's call is being recorded for replay purposes and if you object, you may disconnect at any time. As a reminder, there will be a question-and-answer session following today's presentation. (Operator Instructions)

Now I would like to introduce your call to Jill Krutick, Senior Vice President of Investor Relations and Corporate Development. You may begin.

Jill Krutick

Thank you very much. Good morning, everyone. Welcome to Warner Music Group's fiscal first quarter conference call. Hopefully you have seen the press release we issued this morning with our results. We also filed our Form 10-Q today, which you can find on our website at wmg.com. Today, our Chairman and CEO, Edgar Bronfman Jr., will share with you our strategic update, and our EVP and CFO, Michael Fleisher, will discuss fiscal first quarter results. Finally, Edgar will wrap up before we take your questions.

Before Edgar's comments, let me remind you that this communication includes forward-looking statements that reflect the current views of Warner Music Group about future events and financial performance. Words such as estimates, expects, plans, intends, believe, should, and will and variations of such words or similar expressions that predict or indicate future events or trends or do not relate to historical matters identify forward-looking statements. Such statements include, but are not limited to, estimates of our future performance, such as the success of future album sales, projected digital sales increases, and gains in physical sales, expected expansion of the online marketplace and market share gains. All forward-looking statements are made as of today and we disclaim any duty to update such statements.

Our expectations, beliefs and projections are expressed in good faith and we believe there is a reasonable basis for them. However, there can be no assurance that management's expectations, beliefs and projections will result or be achieved. Investors should not rely on forward-looking statements because they are subject to a variety of risks, uncertainties, and other factors that could cause actual results that differ materially from our expectations.

Information concerning factors that could cause actual results to differ materially from those in the forward-looking statements is contained in our earnings press release and Form 10-Q and other SEC filings.

We plan to present certain non-GAAP results during this conference call. We have provided scheduled reconciling these results to our GAAP results in our earnings press release posted on our website at wmg.com.

With that, let me turn it over to Edgar. Thank you.

Edgar Bronfman

Thanks, Jill. Welcome, everyone. Thank you all for joining us. As we anticipated on our last earnings call, this was a difficult quarter, in some parts because the industry still faces a challenging environment, but almost entirely due to the comparisons to our very strong first quarter last year.

Today we would like to give you some context around this quarter's results, and since we manage our business for the full fiscal year and not quarter by quarter, tell you what we are doing to build upon the successes we achieved last year,

to continue to deliver on our strategic goals, and to provide shop value to our shareholders.

Let me highlight some of our recent milestones for you.

First, we outperformed the industry by gaining market share. According to Soundscan, we are the only major recording music company to increase our total U.S. album share year over year for calendar '06. Our U.S. album share rose to 18% for 2006, up one percentage point year over year and giving us our highest calendar U.S. album share in four years.

Second, we had $100 million or more in digital revenue for each of the last two quarters. On a percentage of total revenue basis, we remain the leader in digital revenue among the majors. This quarter, our digital revenue was 11% of our total revenue and our domestic recorded music digital revenue was 17% of our total domestic recorded music revenue.

Third, we made great strides in our digital evolution, announcing several agreements to enhance our mobile partnering efforts, video strategy and international digital distribution footprint.

Fourth, despite an unusually light quarterly release schedule, we had some notable A&R achievements that strengthened our competitive position. This is a result of our ongoing A&R strategy to focus on innovative efforts with established artists as well as initiatives to develop new artists, gain share in the fastest growing genres, as evidenced by our acquisition of Roadrunner Records, the leading independent hard rock and heavy metal labels, and to develop local repertoire in the largest international markets, such as Japan.

As I mentioned, we face very tough comparisons against last year's outstanding first quarter. In fact, our top five sellers in the first quarter of 2006 generated unit volumes that we have not seen in that period in five years. Accordingly, our first quarter revenue was 14% lower year over year on a constant-currency basis.

Our strategy when we bought Warner Music in 2004 was to lead the industry transformation from the physical to a digital world. As with any major transformation, we have anticipated fluctuations between periods of strong performance and periods of more challenging times. Experiencing a tough quarter in no way alters our strategy, the way we manage our release schedule, or our confidence in the future of the music business. We continue to be extraordinarily excited about our future.

Now I would like to cover some important developments regarding our digital business and our A&R strategy. We are sustaining our leadership position in the music industry's digital revolution. Warner Music Group remains the only major music company that reported digital album share in the U.S. above its physical album share for the December quarter and the 2006 calendar year. Furthermore, in calendar 2006, we saw a year-over-year growth rate of U.S. digital tracks exceed the industry's growth rate by 13 percentage points, and our digital album growth rate exceeds the industry's growth rate by 15 percentage points.

We have three of the top five best-selling digital tracks in the U.S. for the calendar year, including the top two, Daniel Powter's Bad Day and Gnarls Barkley's Crazy, as well as number four, Sean Paul's Temperature. In fact, Daniel Powter's Bad Day was the first digital single to be certified double-platinum in the U.S., having sold 2 million copies.

We also remain on the leading edge of digital innovation. Thanks to our strong, ongoing partnership with YouTube, we were sponsored as part of YouTube's first ever New Year's Eve countdown, presented by Chevrolet. We have provided special video content from New Year celebrations with our artists, as well as music videos and concert footage. Generating nearly 3 million page views, this countdown was one of the more successful online events to date in the streaming video arena and it underscores how quickly and easily we can reach an audience of critical mass.

This showcases how we are thinking about the business differently, using advertising and other innovative means to monetize our content. Beyond this, we entered into four agreements that highlight our mobile video and other digital licensing efforts. First, we reached a strategic global partnership with Motorola to create new music-based products and experiences for the mobile platform. This marks the first time a music company and a handset manufacturer have established a broad-ranging worldwide agreement to collaborate on the development of digital products, a marketing campaign and strategic planning across multiple devices and featuring a variety of artists.

Our Motorola alliance is representative of the next phase in our mobile strategy as we focus on collaborating with manufacturers to complement and further enhance our carrier distribution footprint by creating the first-rate music experiences on the handset to improved music-driven user interfaces.

One of the first mobile products expected to be offered as part of this agreement is the Moto Experience Pack, essentially a mobile bundle similar in concept to the WAMO pack we debuted last year in Japan through the mobile carrier, KDDI. The Moto Experience Pack is a single file downloaded to a mobile device that contains several music-based products, creating a feature-rich multimedia artist experience on the handset. Moto Experience Packs will be available in the second-half of 2007.

Second, we established a strategic relationship with MobiTV, the global leader in mobile and broadband television and music services, to create exclusive Warner Music artist-branded TV channels across MobiTV's mobile and broadband platforms. This agreement is another opportunity for Warner to transform our huge repository of video content from a secondary marketing expense into a primary profit center to an advertising and pay-for-play revenue model.

Third, we were the first media company to reach a broad content and licensing agreement based on an ad-supported model with Last.fm, a social music networking site. According to Last.fm, the company has more than 15 million listeners per month. Based on user music preferences, Last.fm fashions personalized radio streams and connections to users with similar tastes.

Finally, we strengthened our international digital distribution efforts with the acquisition of a majority stake in Zebralution, a German-based digital distribution company which provides content to a large network of mainstream digital services and niche download portals. This agreement will bolster our international distribution network in an effort to expand our digital leadership position across continental Europe.

Moving to our global releases in A&R initiatives, Warner Music had some notable achievements. Before I detail those for you, I am going to take a moment to describe how we measure our own health and the health of the industry, because I think it may be a little unique, probably not revolutionary, but may be different from what others do. It stems from the way we view ourselves not as a traditional record and songs business, but a broadly-based, music-based content company.

Traditionally, success would be measured by examining sales of album units. That is an important but increasingly irrelevant measurement, as it is only part of the picture. Let me note here that total industry-wide album units sold in the U.S., both physical and digital, fell 4% in the December quarter as compared to the same period last year, according to Soundscan.

We lagged the industry this quarter for year-over-year percentage change in U.S. album unit sales due to a light release schedule, but out-paced the market for the quarter and the year in U.S. catalog album unit sales, rising 4% year over year in the December quarter.

Just looking at album sales misses a substantial part of the picture, and when we analyze the market, we add to digital and physical album sales the album equivalent of digital tracks. Converting the digital tracks sales to album sales using the RIAA standard 10 track per album, the U.S. music industry is down 2% year over year for the quarter and just 1% of the calendar year 2006. If we convert our Warner Music digital track sales to album sales, we outpace the industry, which was down 1%, while we were up 3%.

But even converting digital track sales to album sales provides an incomplete assessment of the market because it ignores the mobile music business and online subscription services. Hopefully the market research industry will soon adopt metrics which permit music companies to compare themselves to each other and to the industry, taking into account every popular format and distribution channel for music, not just physical and digital albums.

In this vein, let me discuss a couple of issues that have been in the news recently: interoperability and digital rights management, or DRM.

Let me be clear: we advocate the continued use of DRM in the protection of our and of our artists' intellectual property. The notion that music does not deserve the same protections as software, television, film, video games or other intellectual property simply because there is an unprotected legacy product available in the physical world is completely without logic or merit.

But let's not lose sight of the core issue. By far the larger issue for consumers in the music industry is interoperability. As a content company, we of course want consumers to seamlessly access our music and to use the music they have purchased on any platform and with any service, physical or digital.

The issue is obscured by asserting that DRM and interoperability is the same thing. They are not. To suggest that they

cannot co-exist is simply incorrect. At Warner Music, we continue to seek a balance between appropriate protections for our intellectual property and a robust and satisfying music experience for consumers. Interoperability sure would enhance that balance, while eliminating DRM would do just the opposite.

We will not abandon DRM, nor will we disadvantage services that are successfully implementing DRM for both content and consumers.

Now, moving beyond digital to our successful A&R investments, for the 2006 calendar year, we gained album unit share in the U.S. year over year in four of the top five musical genres, including top sellers in R&B, alternative and hard music, based on release from artists such as James Blunt, Red Hot Chili Peppers, Josh Groban, Gnarls Barkley, and My Chemical Romance.

Furthering our strategy to enhance our A&R presence in growing genres, on January 29th we completed the acquisition of 73.5% of Roadrunner Music Group, which includes Roadrunner Records, one of the world's leading hard rock and heavy metal labels. Roadrunner will operate as a freestanding label group within our Atlantic Records group. The label's multi-platinum, grammy-nominated artist, Nickelback, whose songs are also published by our own Warner Chappell, is responsible for the number one hard music album for 2005 and 2006 in the U.S. And in four of the last five years, Roadrunner has had at least one of the top five selling hard music acts in the United States.

Despite the small number of releases in this quarter as compared to the much larger output in the prior year quarter, during calendar year 2006 we maintained our momentum in breaking new artists. Atlantic's successful turnaround efforts to build a sustainable artist roster are best illustrated by its six new artists who sold more than 500,000 albums each in the U.S. during 2006. Based on our research, no other record label has achieved this level of success in the United States in breaking new artists in any of the past five years.

Underscoring the creativity of our artists, when the Recording Academy announced nominations for the 49th Annual Grammy Awards, I am delighted that Warner Music Group artists and distributed recordings earned an outstanding 105 nominations, up from 67 nominations last year, with an additional 41 nominations going to Warner Chappell songwriters. Our artists were nominated in virtually every major category and genre.

Also notable is the fact that our own Warner Brothers Records label garnered more Brit Award nominations than any other label in the industry.

We have been successful with our A&R efforts designed to enhance our local repertoire in key international markets and drive international superstars globally. In Japan, the world's second-largest recorded music market, our operating momentum continued into the fiscal first quarter, led both by local artists, including [Kopocuro] and Ayaka, and international artists such as Daniel Powter, James Blunt, and Madonna. As a result, our album share in Japan doubled on a year-over-year basis in both the December quarter to 12% and calendar year 2006 to 8%.

Our local and international repertoire success has expanded beyond Japan to Italy, Spain, France and Germany, where we have seen improved momentum in top sellers.

Turning to music publishing in December we announced a leadership transition at Warner Chappell in an effort to further accelerate the company's performance. We named Dave Johnson our EVP and General Counsel, as Warner Chappell's acting CEO as we undergo a leadership search for Warner Chappell. Dave comes to this role with considerable experience and a broad range of recorded music and music publishing matters. I am pleased that Richard Blackstone will stay on in a consulted role, and I am confident that Dave will build upon the progress to date at Warner Chappell.

In addition, Paul Robinson, our Senior Vice President and Deputy General Counsel, is now our acting General Counsel.

We continue to remind the market that we manage our business for the fiscal year, not any particular quarter. Our light release schedule compared poorly to our exceptionally strong schedule from last year. As we noted during our last earnings call, we continue to expect 2007 to be a back-end weighted year, based on the timing of our release. We also continue to make progress in achieving our internal growth target.

In short, we enter 2007 with the vitality and drive to innovate as we continue to develop and broaden our business and our revenue stream, in keeping with our focus to transition from a company selling records and songs to a music-based content company.

Before turning over the call to Michael, I would like to take a moment to pay tribute to Ahmet Ertegun, who recently passed away at the age of 83. Ahmet was not only the founding Chairman and chief architect of Atlantic Records, but he also played a pivotal role in the creation of the Warner Music Group. He served as an advisor as the entire company grew, both domestically and globally and his influence helped shape the artistic process at Warner Music.

For nearly 60 years, he signed, recorded and developed artists whose creative work would come to define entire genres and shape popular culture from R&B to jazz to rock and roll to pop, and would inspire generations to come.

A few of the many artists that Ahmet personally nurtured include Ray Charles, Bobby Darin, Aretha Franklin, Eric Clapton, Led Zeppelin, The Rolling Stones, and Phil Collins.

For those of us who had the opportunity to work with Ahmet in recent years, we feel truly blessed. He was a vital presence at the company until the very end and he will be missed.

Now, I would like to turn the call over to Michael for a run-through of our financials.

Michael D. Fleisher

Thank you, Edgar, and good morning, everyone. Let me begin by covering some of our key financial highlights. For the quarter, we generated net income of $18 million, or $0.12 per diluted share. Looking at the income statement for the three months ended December 31, 2006, we reported revenue of $928 million, which declined 11% from the same period last year, or 14% on a constant currency basis.

As expected, a tough comparison to the success of our prior year quarter and a challenging industry environment were clearly evident in our results.

Domestic revenue fell 12%, while international revenue declined 16% on a constant currency basis. Declines in our physical recorded music business and to a much lesser extent, our music publishing business, contributed to the revenue declines on a constant currency basis, partially offset by year-over-year increases in our digital business.

In recorded music, quarterly revenue declines in the U.S. and Europe were partially offset by increases in the Asia-Pacific region, particularly Japan. As Edgar mentioned, Japan was a standout again this quarter, with revenue rising more than 70% year over year, as strength in both local and international repertoire propelled sales and album share.

Music publishing quarterly revenue declines in the U.S. and Asia-Pacific region were partially offset by growth in Europe and Latin America.

Our quarterly digital revenue rose 45% to $100 million, or 11% of total revenue, from $69 million or 7% of total revenue in the prior year quarter. Quarterly digital revenue slipped $4 million from $104 million sequentially, driven mainly by the lack of top-selling major artist releases in the quarter. Approximately 65% of our digital revenue is generated in the U.S. and 35% in the rest of the world. This compares to the approximate 70-30 split we averaged over the previous three quarters, perhaps an early sign that we may have begun to make headway in our efforts to improve the momentum in our international digital business.

International digital recorded music revenue, as a share of total international recorded music revenue, more than doubled in the quarter year over year from 3.5% to 7.3%. Our worldwide digital revenue continues to be split about 50-50 between online and mobile. While today, online is still larger than mobile in the U.S. and the reverse is true internationally, we see this distinction continuing to blur as the mobile contribution becomes more prominent in the U.S.

We continue to believe that we are still in the very early stages of a digital music revolution that will flourish as 3G penetration rises, product innovation flows, and broadband expands globally.

Operating income before depreciation and amortization, or OIBDA, declined to $140 million compared to $202 million in the prior year quarter. We experienced a decline in our margins this quarter, which is the result of lower revenue and substantially similar fixed costs.

Last year's first quarter releases outperformed our expectations from both a revenue and OIBDA perspective. They generated substantially higher-than-expected sales volumes in the quarter and therefore, related costs such as marketing expenses did not grow in parallel to the sales achieved. As a result, last year's first quarter had unusually

attractive profit characteristics. With the lack of such blockbuster releases in the current quarter, our OIBDA margin was 15.1%.

Let's now look at the different business segments. Quarterly worldwide recorded music revenue fell 16% to $800 million on a constant currency basis. Contributing to this decline was a tough comparison against strong releases in last year's quarter, which included Madonna and Enya, as well as significant carryover sales from James Blunt and two pieces of Green Day product.

Our top five sellers in the first quarter of 2006 accounted for nearly 16 million units worldwide, a sales magnitude we have not seen in that quarter in five years. In fact, three of the top five sellers of all of 2006 had peak unit sales in the first quarter of that year.

Furthermore, the benefit of our successful first quarter of 2006 releases reverberated in the second quarter as well, when James Blunt's album reached its peak worldwide success. As a result of this and other significant second quarter 2006 successes, we believe our comparisons remain tough in our second quarter of 2007 as well. Furthermore, as we have previously stated, we expect fiscal 2007 to be back-end weighted based on the timing of our release schedule.

Domestic recorded music revenue fell 11% in the quarter and international recorded music revenue declined 19% on a constant currency basis from the prior year, as the large releases and successful carryover albums in the prior year had significant international sales.

Recorded music digital revenue grew 45% from the prior year quarter to $93 million, or 12% of total recorded music revenue. Domestic recorded music digital revenue amounted to $61 million, or 17% of total domestic recorded music revenue, up from 11% last year.

Major sellers for the quarter included Josh Groban, My Chemical Romance, Eric Clapton, Diddy, and Luis Miguel.

Quarterly recorded music OIBDA was $141 million, a 32% decline year over year, which reflected the tough comparisons, lower revenues on a similar fixed cost basis, and a difficult industry backdrop.

Let's move on to our music publishing business. In comparison to the same quarterly period in 2006, music publishing revenue grew 1.5% to $133 million, but fell 3% on a constant currency basis. Improved international performance was offset by weak domestic results.

All international revenue sources, mechanical, performance, synchronization and digital, were flat to up year over year, highlighting the initial benefits of our turnaround initiatives. Our domestic revenue components were down modestly, except for improved digital results.

Music publishing OIBDA decreased 10% over the prior year quarter to $19 million, as we continue to invest to drive our long-term growth plan.

As for our cash management and our balance sheet, we ended the quarter with a cash and short-term investments balance of $337 million, which consisted of $327 million in cash and $10 million in short-term investments. Total net debt amounted to approximately $1.9 billion.

We declared our quarterly dividend of $0.13 per share on December 29th, giving us a yield of 2% based on yesterday's close. The dividend will be paid on February 16th. We maintain our intention to pay up to an $80 million annual dividend to shareholders on a quarterly basis.

For the quarter, we generated free cash flow of $16 million. Our free cash flow is calculated by taking cash from operations of $37 million less CapEx of $5 million and net cash paid for investments of $16 million. Our un-levered after-tax cash flow we believe provides the most accurate reflection of the ongoing cash generation capability of our business. Un-levered after-tax cash flow, calculated by adding back $49 million in cash interest to free cash flow, was $65 million in the quarter.

Our cash conversion, calculated by taking un-levered after-tax cash flow and dividing by OIBDA of $140 million, was 46%, as compared to a conversion rate of 30% for last year's quarter.

On the tax front, our net cash taxes were $15 million for the quarter. Substantially all of our income taxes are being paid

outside the U.S. because our U.S. taxable income is being offset by our interest expense deduction and the annual recurring non-cash amortization deduction.

For the three months ended December 31, 2006, we had a tax provision of $15 million on pre-tax earnings of $33 million, giving us an effective tax rate of 45.5%. This rate is above the prior year quarterly rate of 30% because of a greater income contribution from countries with higher tax rates outside the U.S. and because we continue to shield substantially all of our U.S. income.

We do not manage our business for any single quarter. We strive to release the right content at the right time in an effort to maximize fiscal year profit and artist career development. As a matter of policy, we do not provide financial guidance to the investment community, given the quarterly variations in the timing of our music release schedule and associated marketing and promotional expenses are normal.

We are confident in our ability to execute on our transformation agenda for the remainder of this fiscal year and beyond, and we remain pleased with our financial strength, digital leadership, and cost management efforts.

Now, I would like to turn the call back to Edgar for closing remarks.

Edgar Bronfman

Thanks, Michael. Over the course of this upcoming year, we have an agenda that builds upon the success of the last year. We plan to sustain the digital leadership position and enable and promote new business models. We will increase our margin and market share through our multi-pronged A&R strategy, and we will drive profitable growth through innovation and cash flow generation through financial discipline.

Our goal is to continue to drive shareholder value over the fiscal year and beyond as our transformation continues. We look forward to answering your questions about our business. Thank you. Operator, would you please open it up for Q&A?

Question-and-Answer Session

Operator

(Operator Instructions)

Our first question comes from Doug Mitchelson. Your line is open. Please state your company name.

Doug Mitchelson - Deutsche Bank

Deutsche Bank. Thank you very much. One thing that struck me as Mr. Jobs announced his willingness to drop music DRM is that negotiating leverage has begun to shift. I felt initially Apple had the upper hand in negotiations with music labels, given the impact on your business from piracy and the promise of digital growth he could provide, but now the sale of iPods and revenue from iTunes and soon his iPhone are beginning to dominate results for Apple, and perhaps now music has become as important or more important to his stock price than it is for yours. Do you have any thoughts on that?

Edgar Bronfman

You know, I do not think it is helpful to talk about who has more leverage in a negotiation. What I feel is that the more that the music industry and Apple can work together, it seems sensible to do so for both industries. I think more dialog between the industry and Apple could only be a positive thing and frankly, manifestos in advance of those discussions I think are counter-productive.

Doug Mitchelson - Deutsche Bank

All right, well can I follow-up then with, any comments on where negotiations with satellite radio stand? I just wanted to confirm that any increase in license fee rates retroactive to the beginning of this calendar year. Thanks.

Edgar Bronfman

Doug, by statute, any increase in rate would be retroactive to the beginning of this year. At the moment, satellite radio negotiations are proceeding as per the arbitration proceedings that are embedded in the original agreement, which means to say that what they are willing to pay and what we are willing to license for are widely apart and we will be in arbitration to determine what the appropriate rate is.

There is no way to suggest that we know what the outcome will be. I am reasonably confident that the outcome, we will do better than we are currently doing. How much better, we will have to see, but whatever that increase is, it will be retroactive to January 1.

Doug Mitchelson - Deutsche Bank

Then, just timing of arbitration. I know you probably cannot predict exact dates, but is it something that takes one month, three months, six months?

Edgar Bronfman

I would say it is probably -- you know, it is a lengthy process and I think we should probably be hearing something towards -- it should be done I would think probably by the end of the year. It could slip into early next year but I think hopefully it will get done this year.

Doug Mitchelson - Deutsche Bank

Great, thank you very much.

Operator

Our next question comes from Eric Handler. Please state your company name.

Eric Handler - Lehman Brothers

I wonder, is it possible that you can give us a sense of what the average price per SKU has increased over the last year for some of your mobile products, since there is not a lot of pricing leverage on the digital download side.

Secondly, can you give a sense of your ADA business has done quite well this year and you have acquired Ryko. The independent side of your business, just how big is that in terms of total revenue, or a percentage of total revenue?

Edgar Bronfman

I do not think we break out individual pieces, but I will let Michael answer the second part of that question if it is a different answer than the one I just gave.

To the first, I want to point two things out. One, to answer your question directly, I believe our pricing on the mobile platforms has remained relatively flat. There has been no diminution in pricing to the mobile platforms this year. But the further point I want to make is when you are talking about digital pricing, whether it is online or in mobile, it is a different dynamic than when you look at pricing in the physical model. That is to say that there is much more profit opportunity given our model in the digital world for dramatic volume growth than anything else, so I do not think we should be quite so fixated on the margin per SKU in the digital world, because whether we are reproducing one file or one billion files, our costs remain effectively the same. So we are obviously focused on maintaining margins but we are also focused on finding consumer propositions that will drive dramatic uptake and significant volume.

Michael, do you want to talk about the --

Michael D. Fleisher

Eric, we do not break out separately ADA, which is our alternative distribution alliance, the independent group, but if you

looked at Soundscan numbers, which are public, you would find that is about, for 2006 that was about 2.5 points of market share, just to give you a scale.

Eric Handler - Lehman Brothers

Thank you.

Operator

Thank you. Our next question comes from Anthony Noto and please state your company name.

Ingrid Cheung - Goldman Sachs

Hi, this is actually Ingrid Cheung for Anthony, and it's Goldman Sachs. Our question this morning is we recognize that you tough comps in the quarter, but we were a little surprised that digital revenue was down sequentially. To us, that implies that digital growth has probably matured. We were wondering if you were surprised by this decline and think the March quarter could be up.

Edgar Bronfman

Ingrid, we do not give any guidance so I am not going to give you any visibility into the March quarter, but we were not surprised at all, and I think one of the things we have been saying for several quarters now is that as digital becomes a more meaningful percentage of our total revenue, it is going to fluctuate based on release schedules, just like the physical business does. The way I look at it, at $100 million of digital revenue in the first quarter compared to $69 million the year prior, when the year prior had huge digital sales of Madonna, Enya, Green Day, James Blunt, that that is pretty phenomenal year-over-year growth considering the release schedule.

Yes, I understand there was a $4 million decline sequentially, but I think if you look over the year-over-year compares and what we were selling in the market, I think you will see that there was continued phenomenal growth.

I think the other piece is you look at it and you realize it is still 11% of revenue. So if that started to decline dramatically, I might be more concerned, the way you are. But I am not and it was not off from our expectations as all.

Ingrid Cheung - Goldman Sachs

Okay, fair enough. In terms of your back-half of the year, you said your release schedule should be stronger. Are we looking for additional promotion spend in the second quarter then?

Edgar Bronfman

Again, we do not really give guidance so I do not want to bring you to a conclusion. We definitely have a back-end weighted year. We sometimes have expenses in the prior quarter before the release of something in the early part of the next quarter, but I do not think that you should anticipate that the second quarter would be unusual in that regard.

Ingrid Cheung - Goldman Sachs

Okay, great. Thank you.

Operator

Our next question comes from Bishop Cheen and please state your company name.

Bishop Cheen - Wachovia Securities

The company is Wachovia. Good morning, thanks for taking the question. The light release schedule, as you have pointed out, drives a lot of things. Can you just give us some scale on the release schedule? Can you quantify it for us at all Q1 versus Q1 last year? Or give us an idea percentage wise how much bigger the release schedule might be in

the second-half versus the first-half?

Edgar Bronfman

Bishop, it is hard for me to do the going forward stuff for the first-half because as you know, we just do not disclose that information. I think the most relevant comparison, if you look at the top five last year in the first quarter, the top five selling pieces of product did 16 million units. The top five this quarter did 7.5 million, so you really get a sense of it was extraordinary volume movers last year.

I think the other thing I would re-emphasize is that obviously everybody understands how that moves revenue, but I think it is important to highlight what I talked about a minute ago on the call, which is the notion that last year, because some of those big movers had much better-than-expected volumes, the profit was unusual last year. So I think it affects the comparison on both the revenue and the OIBDA line.

Bishop Cheen - Wachovia Securities

One follow-up: in terms of digital distribution domestically, do you expect to see a lot more distribution opportunities for you on the web, via various new downloading sites, or do you think there is a lot more upside for you in the mobile platform?

Edgar Bronfman

I would say both, Bishop. I think first of all, you are starting to see the beginnings, the earliest beginnings of the maturation of sites like YouTube, MySpace, others that really from a commerce-enabled standpoint are only just beginning to get started. First of all, they are just beginning getting started as companies, somewhere between 1.5 years old and 3 years old. But none of them really adept yet at creating real commerce. That of course is coming.

So sites like that, Face Book, many others, you are going to see I think significant businesses built on the web around social networking and those things that drive social network, music chief among them. So there is a tremendous monetization ahead of us as those businesses build and mature.

I think equally on the mobile side, and I say this quite frankly, I think the coming of the iPhone is a very, very positive development for consumers, for the music industry, and frankly for the carriers and other manufacturers. We have always said that we think one of the things that has held back the mobile industry from being a much greater factor in content distribution than it has been so far has been sort of the lack of really outstanding user interfaces.

I think what Apple has demonstrated, we will see if it works, but given Apple's history, I am sure that it will. They have created a phone that not only looks good but suggests that you can operate it in a way that makes your content, the acquisition and playing of your content simple, easy and fun.

Now, the entire industry essentially has a paradigm. They have a bar to shoot at. I think that you will see from Nokia and Motorola and LG and Samsung and Sony Ericcson and the other manufacturers and the carriers a significant increase in effort and focus to match or exceed the bar that has now been set by the iPhone introduction. That can only be positive for the music industry. I expect that 2007 and 2008 will be sort of the defining years for when mobile becomes a significant part of the music distribution picture.

Bishop Cheen - Wachovia Securities

Thank you, Edgar, appreciate it.

Operator

Thank you. Our next question comes from Michael Savner. Please state your company name.

Michael Savner - Banc of America Securities

Good morning, Banc of America Securities. Edgar, as you approach your renegotiations with iTunes for carriage, can you just talk conceptually about what has changed over the last couple of years in terms of what is more important to

you today as you look to renew your distribution, and maybe what is less important today?

Then, Michael, two quick model questions, and I apologize if I missed it. Was the bump in international publishing revenue during the quarter? Secondly, I think a year or so ago we talked about advances to artists on an annual basis probably being in the $50 million to $60 million range, and would probably grow modestly from there. Could you just talk about if that is conceptually still the right way to think about that line? Thanks very much.

Edgar Bronfman

I really think, as a I said earlier in the call, conversations between the industry and/or individual companies and Apple really are best conducted privately. I do not want to preview our negotiations in public. We prefer to have those discussions privately with Apple and that is the approach that we intend to take.

Michael J. Griffith

Michael, on the international publishing, there is nothing unusual. As you will remember, the way revenue is accounted for and our publishing business is on a cash basis, and we are somewhat at the mercy of the collection societies internationally and it literally is when they send us a check, we book the revenue. So there it sort of flows up and flows down from a quarter-to-quarter perspective that are not ones that we sort of actively manage. We just deal with them as they arrive, so there is nothing unusual there. It is just when the collection societies send us the money.

On advances to artists, nothing has changed. I think our strategy is still the same, which is a tighter roster of artists with whom we invest more behind, and therefore you will continue to see us put our money against advances for our key artists, both new and established.

Michael Savner - Banc of America Securities

Thanks very much.

Operator

Our next question comes from Jolanta Masojada, and please state your company name.

Jolanta Masojada - Credit Suisse

Credit Suisse. Michael, I wonder if you could give us a bit more clarity on cost issues going forward in the current financial year. Your music publishing costs were up in the quarter and corporate was down and recorded music was down. Could you talk about what your expectations are for music publishing for the full year? On the recorded music side, are there any particular initiatives underway to help reduce the fixed costs space, given its ongoing in physical sales?

Michael D. Fleisher

First of all, I will restate: I'm not going to give guidance for the year on costs anymore than I am on revenue, but here is how things are playing out. On the music publishing business, as we have said before, we continue to invest more there, partly in infrastructure and people to generate revenue off of our incredible catalog, and also in part in new artist signings, both of which run through the cost in the P&L line, so that is what you are continuing to see in that business. I think you will continue to see that on a year-over-year comparison basis, as we continue to make investments there to drive long-term revenue growth.

On the recorded music side, I think what you are generally seeing is again the costs fluctuate to some extent with the revenue. We have a dramatically variable cost structure, generally, and so if we have a lighter release schedule, as we did this past quarter, we are going to spend less money on marketing and promotion and all of the other expenses.

Across the board and across our company, we remain pretty vigilant about managing our costs. This is something we have been doing since 2004 when we dramatically reduced the cost structure here. We haven't let off that, and so I think you will continue to see us over the course of this year and into the future, manage our costs aggressively. If we think there are places where we can be more efficient, if there are places where we can take costs out, if there are

places where our costs are not aligned correctly with the market, you will continue to see us manage that process.

One piece in particular, as we continue to be aggressive in trying to find costs that are directly tied to the physical side of our business and get those costs out or turn into a variable nature so that we can move those costs over to investments in the digital side, and I think you will continue to see us do that over the next few quarters.

Operator

Our next question comes from Mark Sugarman and please state your company name.

Mark Sugarman - Citigroup

Yes, it is Citigroup. I have three questions, actually. The first is 2007, the early data from Soundscan is pretty eye-catchingly weak. Can you give us a sense of whether you think that is release schedule driven, or is there some other reason why the market has taken such a big dive in the first month? Maybe you could provide us with a sense of what the top 20 albums year over year look like versus the top 200, or something like that.

Second question is you provided some interesting analysis on the U.S. in Q4, when you brought down physical and digital albums and then singles, mobile and subscription. Do you have similar data internationally as well to give us a sense of how physical in the total market has been doing outside of the U.S.?

The third question is just on pricing. You talked about mobile pricing, but how are the trends in physical pricing? Thanks.

Edgar Bronfman

Mark, let me at least do the last one, and then maybe, Michael, you can talk about the first two. On pricing, we have seen essentially no diminution in pricing across the board, whether that is on the mobile platforms, on the digital online platforms or on physical platforms. Our wholesale margins remain essentially constant year over year, quarter over quarter.

Michael D. Fleisher

Mark, to answer your other questions, I think on the physical versus digital detail, we are endeavoring to give everybody more and more information. We will continue to do that. I do not have anything more to report specifically on international today, but point noted and we will continue to work to give more detail so that people can understand what is going on there better.

On what has happened in the first five or six weeks of the year, we think it is very much release schedule driven. I am hopeful that people are not going to look at five or six weeks and try and project the year, because that certainly would be bad in previous periods.

In particular, if you look at 2006, in January last year, the industry had several major releases in January: Mary J. Blige, Jamie Foxx, Eminem, and Notorious B.I.G., so there were real releases last year driving post-holiday volumes and there haven't been any major releases almost across the industry in a substantive way, until this week with Norah Jones.

Edgar Bronfman

Until this week, right. So I think it is, I would agree with Michael, it is very much release driven. We do not expect January to be a harbinger of the year.

Mark Sugarman - Citigroup

Can I ask one other follow-up? There was a question before where you talked about looking particularly at physical costs. There was an article in one of the papers over here in Europe earlier this week which talked about the movie industry, the relationship with retail and saying that the movie industry for the first time is allowing retailers to burn DVDs in-store and then sell them to customers. Is that something that the music industry could do and would cut distribution costs, at the very least?

Edgar Bronfman

We already do that. We do that in many countries with many different suppliers, in what we call kiosk agreements or other kinds of agreements with retailers, where consumers can go into -- it depends on the store and the nature of the retailer, but let's say in a traditional music retailer where consumers can go into the store and really burn their own CD from a selection of different artists, different songs, et cetera. Retailers are looking at that as potentially a way to increase their business and spending more money up against it. It is not yet a large part of our retail business, to be sure, but we already have that technology in place and licenses, many, many licenses for that business.

Mark Sugarman - Citigroup

Thank you very much.

Operator

Our next question comes from Ian Whittaker, and please state your company name.

Ian Whittaker - UBS

Most of the questions have been answered, but just one quick one, actually. Vivendi was saying earlier this week that basically they expect 2007 to be better in terms of recording music simply because of the release schedule. Now, I think you mentioned earlier that over this calendar year, you actually expect to gain market share, so Vivendi is actually gaining market share. You seem to be gaining market share. Are you taking a share really from the other music majors or is it coming from the independents, or what is your sort of gut feel as to how things will progress?

Edgar Bronfman

It is particularly interesting for me to answer a comment about Universal Music Group's prospects, having been there and being a great admirer of the people who basically all of whom were there when I was there. I admired them then and I admire them now. They are a very good music company and I think they will continue to do well. I think, frankly, we are a pretty good music company. I think we will continue to do well.

I think getting market share, ultimately while it is an important measure of our growth within the industry, the more important factor is to make sure the industry grows, so whether we pick up half a point or a quarter of a point or five points, frankly, of market share, it is going to be really less meaningful than it would be if we had the industry growing at a more rapid clip.

Our first focus really is to do everything we can as an industry to take the approaches, follow the policies and promote the initiatives that can allow the industry to grow, and then -- I wouldn't say secondarily, but then focus on our own company mission, which is to create our own growth and take market share as a result of our growth outpacing others.

That's really how we think about it. Of course, we have embraced the independent community in a way that other companies have yet to do, so that we hope our growth will include not only our major releases and our more traditional product but also increased momentum with the independent sector as well.

Ian Whittaker - UBS

Just a quick follow-up question, I think Mark mentioned the U.S. Soundscan data year-to-date. I know it obviously depends on the release schedule, but are there any other sort of international markets, major international markets that you perhaps are quietly confident on in terms of recovery of music sales?

Edgar Bronfman

Of which we are quietly confident? I think it varies market to market, and I think if you are asking in '07 year, I would simply say I really would not predict either optimism or pessimism based on four or five weeks of data, and particularly, international markets report more slowly, so the amount of data we have in the U.S. is actually far greater than year-to-date data that we have in most of the European markets, so even based on say three or four weeks of data from international markets, I just wouldn't -- I do not want to be optimistic or pessimistic, because I just do not think I have

enough data to be either one. I do not want that answer to indicate either one or the other. It is just I do not have enough data to be hopeful to you in saying this market will or will not perform well based on early returns.

Ian Whittaker - UBS

Okay, thanks very much.

Edgar Bronfman

Okay, I think with that I want to say thank you to everyone who has followed us in the past, who continues to follow us. We appreciate your time and attention and look forward to speaking to you again at the end of our second quarter. Bye-bye.

Operator

That does conclude today's conference. You may disconnect at this time.